OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

Timothy L. Firestine
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August 17, 2007

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended June 30, 2007. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of the Montgomery County Code.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. In addition to Montgomery County Government, participating agencies and subdivisions include the Montgomery County Revenue Authority, Housing Opportunities Commission of Montgomery County, independent fire/rescue corporations, Town of Chevy Chase, Strathmore Hall Foundation, Inc., Washington Suburban Transit Commission, Montgomery County Federal Credit Union, and certain employees of the State Department of Assessments and Taxation and the District Court of Maryland. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees. There were an estimated 5,150 active members and 4,844 retirees participating in the ERS as of June 30, 2007.

Performance Results

The total return achieved by the ERS assets for the quarter was a gain of 4.97%, 104 basis points ahead of the 3.93% gain recorded by the policy benchmark. For the one year period ending June 30, 2007 the estimated ERS' gross return (before fees) was 18.79%, 200 basis points ahead of the 16.78% return of the policy benchmark and 10.79% above the 8% actuarial assumed return. The one-year return places the ERS' performance in the top 9% of a universe of public pension funds constructed by the Board's consultant, Wilshire Associates. For the three-year period, our annualized performance was 12.76%, before fees, ranking in the top 21% of the universe. The asset allocation at June 30, 2007 was: Domestic Equities 41.3%, International Equities 20.9%, Fixed Income 23.2%, Inflation Linked Bonds 9.5%, Alternative Investments 3.9%, Real Estate 1.2% and Cash 0.1%. We estimate that the funded status of the ERS has improved to 80.4% as of June 30, 2007, from a 76.2% funded status a year earlier. Note that the actual funded status will be affected by the ERS' membership experience, as well as demographic and economic changes and may be higher or lower when calculated by the actuary later in the year.

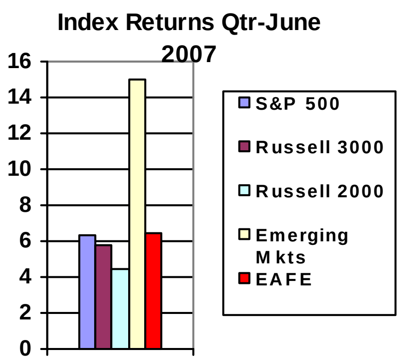
Major Initiatives

During the quarter, the Board continued to implement the revised strategic asset allocation for the ERS by transferring $110,000,000 from domestic equities to fixed income and global inflation indexed securities. A gradual rebalancing of assets and implementation of possible new investment strategies will take place over the next several years which will result in further diversification of the investment portfolio and better management of the total portfolio's risk and stronger investment returns.

The Board also approved a Business Continuity Plan which documents the procedures that Board staff, the County, and Board vendors will follow in the event of a disaster to minimize or eliminate the disruption of the Board's investment programs and service to the retirement plan participants. In addition, the Board approved the issuance of a Request for Proposal for equity managers who have the capability to invest in both long and short portfolios.

Capital Markets and Economic Conditions

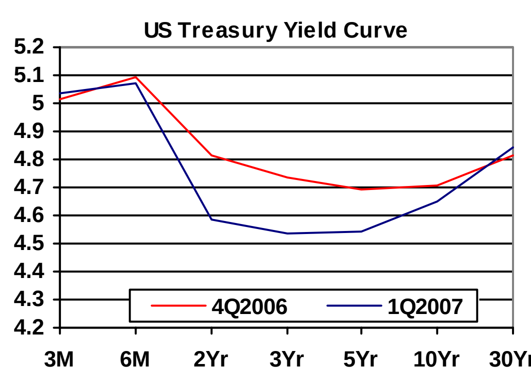
The equity markets finished the quarter up, although this was mainly due to optimism at the start of the quarter and strong returns in April and May. Despite strength in the mergers and acquisitions market, oil prices continued to climb above $70 per barrel and ongoing economic concerns caused investors to become increasingly cautious. Increased uncertainty drove bond yields above the 5% level and there was a marked rise in market volatility. The economic indicators point to a relatively soft landing for the US economy, a measure of success for the Federal Reserve. The Fed has left interest rates on hold at 5.25% again and there is a growing feeling that they will continue to hold rates until the end of 2007, a marked change in sentiment from the start of the year. Inflationary pressures continue to be their primary concern, although estimates suggest growth in the US of around 3% in 2007, well below the estimated global growth of 5%. Internationally, the Bank of England kept interest rates to 5.50%, while the European Central Bank raised rates for an eighth time, to 4.0%.



The U.S. equity markets continued to post positive returns during the second quarter despite the concerns over a slowing housing market, rising sub-prime default rates, and higher oil prices. As shown in the chart to the left, the large capitalization firms (as represented by the S&P 500 Index) outperformed smaller capitalization firms (as represented by the Russell 2000 Index). Growth stocks outperformed value stocks across the capitalization spectrum. The top performing sectors of the S&P 500 during the quarter were energy, IT, and basic materials while utilities were the worst performing sector. Our combined domestic equity performance was a gain of 6.30%, 53 basis points ahead of the Russell 3000 benchmark index return. For the one year period ending June 30, our combined domestic equity performance was 21.48%, 141 basis points ahead of the benchmark.

Within the international markets, developed markets, as measured by the MSCI EAFE Index, were up 6.40% for the quarter compared to emerging markets which gained 14.96%. All EAFE markets except Japan (-0.64%) posted positive returns with Portugal (+17.64%) and Germany (+16.17%) posting the highest returns. The markets of Peru (+33.56%) and Hungary (+28.73%) ranked among the top performing countries within the emerging markets sector. Our combined international equity performance was a gain of 8.31% (before currency managers' performance and 9.25% after) for the quarter, 12 basis points ahead of the benchmark index's return of 8.19%.

During the second quarter, the strongest currencies where the dollar markets of New Zealand (+8.3%) and Australia (+5.0%) while the Japanese yen depreciated strongly (-4.3%) and reached its lowest value in 2007. Most of the major emerging market currencies appreciated against the U.S. dollar during the quarter. Our currency managers added 0.94% for the quarter.



A marked increase in volatility had a large impact on the fixed income markets through the quarter. 10-year Treasuries began the quarter at 4.65% and ended the month of June above 5.0% - hitting 5.25% at one stage, the highest closing level in 5 years. Yield rises were more pronounced for longer duration paper and this caused the yield curve to steepen (see right). Although concerns about inflation caused yields to widen, this created more demand for long duration Treasuries (as a flight to quality for investors), helping to push the yield for 10-year Treasuries back down towards the 5.0% level. The ERS combined fixed income return for the quarter was a slight loss of -0.24% ahead of -0.51% recorded by the benchmark index. Investments in inflation-linked bonds were down -1.10% for the quarter, 18 basis points ahead of the benchmark's negative return of -1.28%.

Additions

The primary sources of additions for the ERS include member and employer contributions and investment income. The following tables show the source and amount of additions for the quarter ending June 30, 2007 and fiscal year-to-date.

Employees' Retirement System
Contributions and Investment Income (millions)

	Qtr 6/30/2007	Fiscal YTD
Employer Contributions	$ 27.6	$ 109.4
Member Contributions	4.1	16.4
Net Investment Income	124.4	416.3
	$ 156.1	$ 542.1

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

Employees' Retirement System
Deductions by Type (millions)

	Qtr 6/30/2007	Fiscal YTD
Benefits	$ 34.4	$ 136.7
Refunds	0.2	0.8
Administrative Expenses	0.7	2.4
	$ 35.3	$ 139.9

Outlook

Since last quarter, there has been increased wariness over the state of the global economy and signs of volatility are starting to return. This causes fluctuating market returns, but it also increases the opportunity set for our active managers to increase value. From a domestic perspective, worries of contagion effects from the subprime debacle appear to be receding, so focus again reverts to low interest rates and limited domestic economic growth. The economic boom in China and Asia has meant that their central banks (along with the oil producing countries) have significant excess capital to invest, generally targeting US bonds, although this is changing. Interest rates are still low and the dollar relatively high, creating an unstable economic outlook.

Low interest rates have also provided great liquidity and combined with low volatility, have maintained an easy lending environment. This access to cheap free cashflow has ensured a steady supply of capital to invest and private equity firms in particular are utilizing the opportunity to assess merger and acquisition opportunities. Low volatility and higher prices have also encouraged some investors to leverage up their investments with the aim of maintaining returns. This increases the probability of a major financial event and the search for return could easily change to widespread market fear. A diversified asset allocation is the best way of managing against these risks and we continue to diversify the underlying ERS asset mix.

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS
June 30, 2007

Assets	
Equity in pooled cash and investments	$ 289,362
Investments:	
Northern Trust	2,693,986,346
Aetna	11,660,269
Fidelity - Elected Officals Plan	1,045,987
Total Investments	2,706,692,602
Contributions Receivable	7,291,481
Total Assets	2,714,273,445
Liabilities	
Benefits payable and other liabilities	4,442,068
Net assets held in trust for pension benefits	$ 2,709,831,377

EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS
June 30, 2007

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	$ 27,607,141	$ 109,436,001
Member	4,018,926	16,362,462
Total Contributions	31,626,067	125,798,463
Investment Income	128,193,036	428,352,010
Less Investment Expenses	3,750,678	12,014,952
Net Investment Income	124,442,358	416,337,058
Total Additions	156,068,425	542,135,521
Deductions		
Retiree benefits	24,640,548	98,652,678
Disability benefits	8,260,452	32,228,463
Survivor benefits	1,513,276	5,951,967
Refunds	193,880	778,961
Administrative expenses	661,659	2,371,637
Total deductions	35,269,815	139,983,706
Net increase	**120,798,610**	**402,151,815**
Net asset held in trust for pension benefits		
Beginning of period	**2,589,032,767**	**2,307,679,562**
End of period	**$ 2,709,831,377**	**$ 2,709,831,377**